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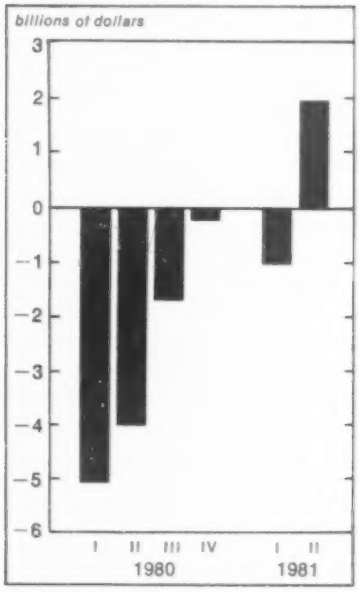
Japanese Exports to Continue to Fuel Growth

The Japanese authorities are beginning to show concern about the slow recovery of the domestic economy. The government had been counting on a pickup in domestic demand to provide a strong impetus to growth and to alleviate some of the pressure to export. However, so far this year most of the momentum for growth has come from net exports. Housing remains extremely depressed, and private plant and equipment investment, particularly by smaller firms, appears to be slowing. Private consumption spending has shown some revival recently, with the 7.7% average wage increase resulting from this spring's labor negotiations and the moderation of consumer price inflation to just over 5%. Nevertheless, consumer spending remains relatively sluggish.

Japan's current account performance
(seasonally adjusted)



Concerned that the economy's continued reliance on external demand will provoke sharp foreign reaction, the Economic Planning Agency and the Ministry for International Trade and Industry are reportedly pushing for a new package of measures to stimulate the domestic economy and boost imports. The measures available to the Japanese government are quite limited, however. High U.S. interest rates and an already-weak yen preclude a cut in the discount rate, and fiscal stimulation is limited by the government's desire to reduce the budget deficit. Subsidies in support of $3 billion of emergency imports, an acceleration in public-works spending, and a relaxation of conditions for public housing financing have been proposed. But any measures taken are likely to have relatively little impact.

Despite any initiatives to spur a pickup in the domestic economy and imports, Japan's balance-of-payments showing is likely to draw renewed criticism from its trading partners. Exports have continued to surge—led by color television sets and videotape recorders—while imports, particularly of oil, have been soft because of the weakness of the domestic economy. For the first six months of 1981, Japan recorded a seasonally adjusted current-account surplus of $1 billion. Although exports may slow and imports may accelerate in the second half of the year, the current account for 1981 as a whole could register a surplus of $2 billion, a sharp turnaround from the deficit of $10.8 billion in 1980. And with a recovery in the world economy, the recent depreciation of the yen against the dollar, and the strong non-price competitiveness of Japan's export products, Japan may be poised for an export boom that could push the current-account surplus to the $5-$10 billion range next year.

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Sterling weakness threatens to undermine U.K. progress on inflation.

The U.K. economy appears to be signaling an end to the recessionary slide. Retail sales volume is up 10% over last year, and the June industrial production index posted its first significant climb in many months (1%). Even unemployment, up to 10.7%, is now rising only slowly. These encouraging signs, however, are being overshadowed by sterling's weakness, which, combined with the dollar's strength, has seen the pound's exchange rate fall back down to its 1977 levels. Sterling weakness threatens to undermine the recession-induced declines in inflation because raw material prices are now rising fast in sterling terms, and British firms, with profits already squeezed, will have no choice but to pass on price increases. The government has been unwilling to defend sterling by boosting interest rates, and U.K. ministers have been stressing the need for moderate wage settlements in the new pay round that began in July. The prospective inflationary pressure is causing growing concern that the United Kingdom, currently paying the short-term cost of Mrs. Thatcher's policies, may fail to enjoy the long-term benefits.

Norway's oil boom has negative consequences for inflation and competitiveness.

Norway's developing oil sector has continued to put inflationary pressure on the domestic economy. Wages in the oil sector have been bid up to attract scarce labor, and the non-oil sector has responded by raising its own wages, thereby increasing costs and further reducing competitiveness. The exchange rate provides little relief since the kroner remains in demand because of Norway's rising oil production and continued high oil prices. The heightened pressure is showing up in the consumer price index, which has climbed rapidly this year to reach a year-over-year increase of 13.9% in June and 14.2% in July. The July figure was sufficiently large to trigger wage increases under Norway's indexation system agreed on between labor and management. But just before the wage rises were to be announced, the minority labor government—which faces an election on September 14—put a freeze on domestic prices and wages through yearend. Unless efforts are made to deal with the underlying causes of inflation, however, the rate of price rise is likely to accelerate once the freeze is lifted--as happened when the last 15-month freeze ended in January 1980. With the upcoming election almost certain to fail to give any party the large majority needed to implement effective anti-inflation policies, the prospects for Norwegian inflation and competitiveness are uncertain. What is likely is that the next administration will opt for a creative shift in policy that would allow Norway to take fuller advantage of its new-found oil wealth.

Uruguay faced with challenges to rapid growth and reserves position.

With the exception of 1979, real economic growth in Uruguay has averaged a healthy 4% per annum since 1977—much greater than the population growth rate of less than 1%. And more recently, progress on inflation has seen the year-over-year rate brought down from an average 65% per annum in 1979-80 to 35% this past June. The current-account deficit has widened markedly, to $480 million in 1980 from $126 million in 1978, however, reflecting an import liberalization policy and an overvalued exchange rate. But capital inflows have more than met the country's financial requirements, allowing gross international reserves to rise rapidly, to $530 million from $290 million at end-1978. Developments both on the internal political and external fronts, however, pose potential obstacles to continued progress. These include the transfer of power to a new president in September and the economic instability in Argentina, upon which Uruguay is heavily dependent for exports, tourism, and capital.

Taiwanese currency's link with U.S. dollar prompts a devaluation.

Responding to the reduced price competitiveness of its exports, Taiwan's central bank devalued the New Taiwan dollar by about 4.8% on August 12. The Taiwanese currency, which is pegged to the U.S. currency and has remained stable in U.S. dollar terms since the early 1960s, fell from 36.24 per U.S. dollar to about 38.00 The move was aimed largely at offsetting the reduced price com-

petitiveness of exports to Europe and Japan brought about by the U.S. dollar's appreciation. Taiwanese exports have been reasonably strong in 1981, totaling $12.8 billion for the first seven months—16.1% above the year-earlier figure. Imports during the same period totaled $12.9 billion, up 12.6%. The recent devaluation of the Thai baht and the depreciation in U.S. dollar terms of several other Asian currencies, however, probably convinced the authorities that a move was necessary. The degree of devaluation is modest considering the extent to which the U.S. dollar peg had appreciated Taiwan's currency relative to those of other OECD countries. It undoubtedly represents a compromise between exporters who sought a devaluation of 10% or more and the conservative monetary authorities.

Sri Lanka under IMF pressure to devalue.

The IMF is apparently pressing Sri Lanka to devalue the rupee by 10% as a condition for receiving the final tranche of a SDR 260-million Extended Fund Facility loan. Sri Lanka's domestic prices in recent years have risen more rapidly than international prices, and the movement of the exchange rate has failed to compensate for the differential. As a result, it is increasingly difficult for domestic producers either to export or compete with imports. The current-account deficit, reflecting this, nearly tripled to $667 million in 1980. So far this year, the monetary authorities have allowed the rupee to slip over 9% against the dollar. Nevertheless, because of the dollar's strong appreciation against the European currencies, the rupee has appreciated against the currencies of many of its major trading partners. If the U.S. dollar remains relatively strong—as is expected—the prospects for Sri Lanka's exports and imports will be unfavorable without an accelerated depreciation of the rupee.

Australia's new wage policy implies upward wage pressure.

Amidst widespread labor strikes, the Australian government has abandoned its six-year old centralized wage-fixing system, whereby pay increases were partially indexed to the rate of inflation. The labor market will thus resort to free collective bargaining, although the Arbitration Commission may continue to supervise bargaining and disputes. The abandonment of the wage-fixing system and the recent labor turmoil are the result of a combination of the country's booming economy, led by natural resource development, with the rigidities of the old centralized wage-fixing system. The former system hindered labor mobility between sectors because it could not accommodate the high wage demands of skilled workers created by the resource boom without granting similar increases in low-demand nonresource sectors. The result was a shortage of skilled labor and persistently high unemployment in nonresource sectors. The authorities are hoping that these imbalances will be redressed with free wage bargaining. But heightened expectations suggest strong upward wage pressures. The government is expected to resist with tight fiscal and monetary policies, which should greatly affect Australia's economic performance in the coming year.

Syrian parallel exchange-rate scheme meets with initial success.

In an effort to increase the supply of foreign exchange and eliminate a currency black market, Syria's government recently introduced a number of measures. A parallel flexible-rate foreign-exchange market was established for all private-sector transactions and a few public-sector exports. The parallel rate initially set by the Commercial Bank of Syria was 6.30 Syrian pounds to the U.S. dollar, a 38% devaluation over the official rate of 3.925 pounds per dollar. The aim was to give Syrian workers abroad a greater incentive to channel their remittances through the Syrian banking system and encourage Syrian producers to expand exports. The scheme appears to have had some success to date, with the parallel rate appreciating to about U.S.$1=S£5.00. Meanwhile, both the Syrian Cabinet and Party Central Committee have approved the long-awaited 1981-85 five-year plan. The plan is expected to stress the completion of current projects and give higher priority to light industry and agriculture.

Investment: Tax Incentives Not Enough

With final Congressional approval and President Reagan's signing of the Economic Recovery Tax Act of 1981 earlier this month, advocates of supply-side economics won a notable victory. Contained in the new tax law are a number of measures designed to stimulate capital investment—a key priority of the Reagan administration's supply-oriented strategy to shore up economic growth in the United States and revitalize American productivity. Among the provisions highly favorable to future investment are:

- accelerated depreciation of business structures and capital equipment,
- a reduction in the top tax rate on "unearned," or investment, income to 50% from 70%, and
- a lowering of the maximum tax rate on capital gains to 20% from 28%.

Supply-siders assert that these changes in the tax law are critical to promoting new capital formation. And indeed, they may be. Nevertheless, it is unlikely that the new tax incentives will have a noticeable impact on business investment in new plant and equipment in the near term. This is because the current weakness in investment spending is more the result of other considerations.

Most significant is the lack of vigor in overall demand. Industrial operating rates—a rough measure of the proportion of existing productive capacity currently in use—have been close to 80% for months and have recently fallen below that level. In the past, operating rates have had to move above 85% before they triggered a major expansion of capital spending. Other critical influences on business investment decisions have been the persistence of high interest rates and uncertainty over the future course of inflation.

Over the next few months, interest rates are expected to come down—but not by very much. And inflation, despite a mid-summer spurt, is expected to ease through the end of 1981. But more important, the industrial operating rate should improve slowly after a few more months of economic stagnation. The combination of these changes should be sufficient to start business investment moving upward by the beginning of next year. Nonetheless, investment in 1982 is likely to grow by only about 4% in real terms.

Thus, it appears that supply-siders will have to ride out the business cycle for a while before their theories on taxes and investment can really be tested. Investment growth is not likely to be rapid until the operating rates approach the trigger point. But if the economy regains strength and continues to expand through 1983, the stage will be set for a major investment boom—with the recently enacted tax incentive serving as catalyst.

The Loose Link Between Money and GNP

The money supply this year has seemed to move almost independently of changes in the aggregate demand for goods and services, even on a monthly and quarterly basis. Put another way, perfect foresight of the behavior of GNP this year would have been of little use to money-supply forecasters. This is especially disconcerting in an environment in which short-run movements in money growth play a major role in monetary policy actions.

For example, in the first quarter of this year, current-dollar GNP rose at an annual rate of 19%, while M1-B (adjusted for the estimated effects of shifts into NOW accounts) fell at an annual rate of 1%. And in the second quarter, GNP increased by only 4%, while adjusted M1-B rose by 5¾%. Such behavior is inconsistent with historical relationships among M1-B, GNP, and interest rates. Some observers contend that a downward "shift" in the demand for money has occurred, probably in response to high interest rates.

There are other forces, however, that can cause the short-run relationship between money and GNP to be highly volatile. For one, the relationship between money and income may be of the "lead-lag" variety, rather than contemporaneous. However, any such lead-lag relationships have not been stable recently.

Another such force concerns the adjustments for seasonal variations made to the money supply and to various measures of income and sales. It is widely recognized that the method used to adjust the money supply for seasonal changes is imperfect. Furthermore, the method used to adjust various measures of income and sales differs significantly from that used to adjust the money supply. Both of these forces have affected the behavior of M1-B relative to income this year.

The behavior of bank loans relative to income can also affect the money/income relationship. Such an effect is difficult to quantify, however, since the relationship between money and bank loans is often temporary, and depends on the extent to which changes in loan growth are related to changes in sales.

Finally, the relationship between GNP and total transactions, which some economists believe are a determinant of the demand for money, is often quite loose in the short run. For example, in the first half of this year total business sales—which include intermediate transactions not included in GNP but which must be financed—were much weaker than GNP.

In sum, there are other forces besides "shifts" in the demand for money that can cause substantial short-run variations in the relationship between seasonally adjusted money and income. Unfortunately, determining the cause of any such variations—especially on a contemporaneous basis—is extremely difficult. Of course, these variations may "wash out" over the long run. But in the short run they can have major effects on the course of monetary policy and interest rates, and thus contribute to the uncertainty plaguing financial markets.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	12-month changes: consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars August 26, 1981	change from year earlier	current monetary conditions	
Argentina	New government program will refinance half of private manufacturing industry debts.	Mar.	— 8%	117.0	$4,333	Apr.	5,203	— 42%	6.4	0	Exchange rates stabilizing after recent devaluations.	July	+105%	Dec.	+ 95%	.00016	—68%	Money supply (M1) falls in first four months of 1981.	Argentina
Bahamas	Construction activity rising, paced by government's $150-million hotel expansion program.	Mar.	— 9%	1.2	5,630	June	117	+ 15%	1.4	0	Capital account improving.	April	+ 13%	Mar.	+ 2%	1.0050	+ 3%	Building and construction credit increases.	Bahamas
Bolivia	Economic activity continues to deteriorate.	Dec.	+ 21%	6.1	1,100	May	111	+ 26%	1.5	73	Exchange controls imposed to stem capital flight.	Mar.	+ 36%	Apr.	+ 22%	.0409	+ 5%	Net international reserves falling.	Bolivia
Brazil	Industrial sector in recession, but rate of inflation has declined sharply.	June	+ 18%	237.2	1,991	June	5,200	— 8%	2.6	0	Second monthly trade surplus posted in June.	July	+111%	June	+ 56%	.0098	—45%	Money supply reduction on target.	Brazil
Chile	Industrial growth was a slight 2.6% in first quarter, but inflation rate rose only 5.4% in first half.	June	— 15%	22.8	2,060	June	3,248	+ 25%	5.8	80	January-June exports down 15%, imports up 41% from year earlier.	June	+ 21%	Dec.	+ 58%	.0260	0	Domestic liquidity tight.	Chile
Colombia	Strong import competition contributing to industrial slowdown, especially in textiles, shoes, and plastics.	Mar.	— 31%	36.8	1,360	June	4,609	+ 13%	10.5	0	Reserves decline as coffee income drops.	May	+ 26%	Dec.	+ 28%	.0195	—11%	Bank credit expansion accelerates.	Colombia
Costa Rica	Domestic economic activity decelerating owing to tighter fiscal and credit policies.	May	0	5.0	2,190	June	183	+ 53%	1.6	106	Authorities planning to restructure $2-billion external debt.	May	+ 30%	Dec.	+ 17%	.0590	—50%	Monetary policy restrictive.	Costa Rica
Dominican Republic	Economic growth expected to slow in light of efforts to curb external imbalance.	Mar.	— 4%	6.9	1,280	June	191	+ 15%	1.3	29	Restrictive measures should cut import spending.	Feb.	+ 9%	Mar.	— 3%	Par	—	Liquidity tight.	Dominican Republic
Ecuador	Public spending restrained to offset decline of petroleum export earnings.	May	— 9%	11.0	1,321	June	756	— 13%	4.3	0	Import duties increased on 535 items for revenue purposes.	May	+ 16%	June	+ 22%	.0360	— 3%	Bank deposits increase after early 1981 dip.	Ecuador
Guyana	IMF approves increase in Extended Fund Facility up to 400% of Guyana's quota.	Dec.	+ 33%	0.5	550	June	22	+ 5%	0.9	71	Currency devalued 15% to aid exports.	Dec.	+ 8%	Feb.	+ 1%	.4000	+ 2%	Credit curtailed as public spending is cut.	Guyana
Honduras	Real GDP grew 2% in 1980 versus 7% in 1979; slower growth expected this year.	Feb.	— 9%	2.4	658	Jan.	138	— 33%	1.7	14	New 10% surcharge put on imports, including those from Central America.	Oct.	+ 15%	Apr.	— 3%	.5000	0	Net foreign assets down.	Honduras
Jamaica	Alcoa and Alcan cutback in aluminum output will erode 12% advance in first quarter.	Feb.	+ 27%	3.2	1,460	June	104	— 15%	1.0	377	Imports up 20% in Jan.-Feb., with exports rising 18%.	Jan.	+ 24%	Feb.	+ 13%	.5618	0	Credit availability limited.	Jamaica
Mexico	Shipments of interrupted oil exports are resuming at average price of $30.70 per barrel.	Apr.	+ 58%	167.0	2,300	Jan.	2,918	+ 32%	1.5	0	Import licensing stepped up to cut foreign-goods demand.	July	+ 27%	May	+ 41%	.0403	0	Government treasury financing operations increase.	Mexico
Panama	Manufacturing and construction sectors advance briskly but unemployment still troublesome.	Mar.	+ 22%	3.5	1,805	June	93	— 51%	0.7	29	Large increase in refined oil exports recorded.	Apr.	+ 8%	Dec.	+ 10%	Par	—	Construction loans grow rapidly.	Panama
Paraguay	Plans under study for utilization of hydroelectric power from Itaipu project.	Apr.	+ 38%	4.6	1,505	June	799	+ 17%	15.4	0	Soybean exports increase significantly.	Feb.	+ 19%	Dec.	+ 26%	.0080	0	Credit demand strong.	Paraguay
Peru	General wage rise of 10% mandated for public and non-union private-sector workers.	May	— 16%	17.2	965	Feb.	1,756	+ 26%	7.5	399	Additional import duties lowered, bringing average tariff to 32%.	June	+ 82%	June	+ 47%	.0024	—31%	Domestic credit rising sharply.	Peru
Uruguay	CPI rose 14.5% in first half, compared with 21% during first-half 1980.	Apr.	+ 62%	9.8	3,825	Apr.	596	+ 30%	4.3	0	Exports up 62% in first four months, while imports fell 6%.	June	+ 35%	Sept.	+ 32%	.0950	—14%	Interest rates declining.	Uruguay
Venezuela	Legislation allowing resumed medium-term borrowing in Eurocredit market progressing.	Feb.	+ 20%	51.4	3,690	June	8,913	+ 33%	9.8	0	Capital outflow prompted by low interest rates.	May	+ 18%	Mar.	+ 27%	.2328	0	Credit availability limited.	Venezuela

World Interest Rates

market rates of August 26, 1981; bond yields as of August 21, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	21.03	12.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	17.00 Aug. 27	23.00	12.75	12.15	17.50	12.00	20.125	13.375	2.50	7.375
Treasury Bills 91-day, Middle Rates	15.85 discount basis	20.90	13.25	15.75	n. a.	n. a.	19.086 92-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	17.25 finance paper discount basis	22.00 finance paper 15% tax w/h	12.52	12.90 Certified	17.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	17.30	21.90 15% tax w/h	13.25	12.90 Certified	not traded	9.90	22.70	no market	9.25	no market
Government Bonds Long-term, new and old issues, average yield	14.51	17.00	14.60	11.302 20% tax w/h	16.43	10.78	20.81	12.22	5.72	8.62
Industrial Bonds prime, long-term, new and old issues, average yield	15.55 Aa Industrials	18.125	15.86	17.395	17.75	11.56	21.09	13.55	6.39	7.23
Bank Short-Term Rate to Best Borrowers (prime rate)	20.50	22.75	14.00	18.00	18.50	14.50	22.50 ⅛ quar'ly fee on outstdng.	15.00	9.50	6.75
Bank Time Deposits 3-month	17.75 Cert. of Dep.	21.75	13.9375	15.30	17.75	12.65	10.75	13.75 large deposits	8.50 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	19.25	no market	14.00	no market	28.25	12.6875	no market	13.875	9.375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8235	1.8425	.0248	.1688	.4036	.00081	.3633	.4648	.00434
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.00 *D*	5.00 *P*	2.00 *D*	9.00 *D*	6.00 *P*	15.50 *D*	5.00 *P*	10.00 *P*	11.00 *P*

Eurodollar Deposits
(London, interbank, bid)
Aug. 27

7-day	18.0625
1-month	18.50
3-month	19.00
6-month	19.00

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.218
U.S.-Canada Treasury Bills	−0.743
U.S.-Canada Finance Co. Paper	−1.448
Eurodollars-U.K. Local Auth. Deposits	+0.063

Eurobonds
(average yield on recent straight debt issues)*

U.S. Dollar Bonds	
7 yrs. and under	16.18
Over 7 yrs.	15.89
DM Bonds	
7 yrs. and under	11.25
Over 7 yrs.	10.765

Gold Price
London afternoon fixing
414.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Yields as of August 19, 1981.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	10.7 (July)	13.0 (July)	10.9 (July)	13.1 (June)	5.8 (July)	19.6 (July)	6.6 (July)	5.1 (June)
Industrial production*	9.3 (July)	6.3 (June)	−8.0 (May)	−4.5 (June)	−1.9 (June)	−5.7 (June)	−2.6 (March)	1.9 (June)
Trade balance† *(billions of local currency units)*	−$3.12 (June)	C$0.57 (June)	£0.31 (Feb.)	−FF3.85 (July)	DM1.70 (June)	−Lit.790 (June)	−SF0.51 (July)	¥579 (June)
Money supply (M1)*	7.8 (July)	3.0 (June)	12.5 (June)	10.6 (April)	1.1 (May)	11.9 (April)	−2.3 (May)	−2.4 (April)
Velocity of money (M1)*	12.9 (Mar.)	−0.14 (Dec.)	9.8 (Dec.)	n. a.	0.7 (Mar.)	6.7 (Dec.)	n. a.	10.5 (Dec.)
Reserves minus gold *($ million, change from previous month)*	190 (June)	−110 (June)	−1,124 (June)	−4,045 (June)	−1,508 (June)	−1,603 (May)	−768 (May)	181 (June)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Francophone Africa's Dilemma

Following the socialist victory in France, many investors began selling French stocks and moving their funds into assets denominated in other currencies, responding to fears of a franc depreciation. At the same time, however, capital began pouring into France from the nations of French-speaking Africa. This apparent anomaly is the result of the French-franc-pegging policy of the Francophone African nations, which have chosen to fix their currencies to a major world currency rather than allowing them to float freely. And in view of the shift in the nature and direction of the French government, it has prompted an exchange-policy reappraisal throughout French-speaking Africa.

The CFA (Communauté Financière Africaine) franc is the currency of French-speaking Africa, and two central banks—the Banque Centrale des États de l'Afrique de l'Ouest and the Banque des États de l'Afrique Central—regulate monetary and exchange-rate policy in their respective African regions. Since independence, the Francophone monetary authorities have pegged the CFA franc to the French franc at the ratio of FF1.00 to CFA 50.00.

The economic theory of fixed exchange rates teaches that a reserve-currency country sets the tone for monetary policy and the resulting level of interest and inflation rates in those countries whose currencies are pegged to it. In this sense, pegging countries usually benefit. Other consequences of pegging are even more clearly beneficial. Local capital markets can mature more quickly as they are linked in a stable fashion to well-developed financial markets in the reserve country. Further, investment funds from industrialized countries are more easily attracted, and trade flows are enhanced.

Now, however, Francophone Africa must decide whether it can accept France's new monetary policies and their inflation and interest-rate consequences. Prior to the socialist victory, interest rates in French-speaking Africa were roughly comparable with those in France. But interest rates in France soared after the election to satisfy investor demand for higher returns for holding francs despite expectations of rising inflation and currency depreciation. As interest rates surged in France, the central banks of French-speaking Africa resisted the rise in rates on CFA-denominated assets. This led investors in CFA francs to switch rapidly into French francs at the fixed exchange rate, to earn the higher interest rates paid in France, putting pressure on the CFA franc.

One of three alternative responses—all politically difficult—must be chosen by the Francophone African nations: 1) delinking the CFA franc from the french franc, 2) imposing restrictive currency, capital, and trade controls, or 3) allowing interest rates to rise to a level consistent with those in the reserve-currency country. If no action is taken, market arbitragers will force a rise in interest rates in the African economies.

Delinking the CFA franc from the French franc would be a costly response. It would deprive French-speaking Africa of its major source of economic stabilty: the free convertibility of its currency into French francs and the guarantee of the French treasury to act as lender of last resort. French commercial interests in France would also suffer from the loss of convertibility. French trade with Francophone Africa—a net surplus item—would shrink appreciably. Also, many French citizens working in Africa might feel compelled to return home. This could not only swell unemployment in France, but it would also reduce inward worker remittances.

The introduction of exchange controls applying to dealings within the African French franc zone would also be harmful. Such controls are currently minimal, with the exception of measures relating to gold, and the imposition of stronger controls would require the concurrence of all countries involved—unlikely as long as the monetary union exists.

Therefore, the inevitable Francophone African response—whether voluntary or not—is allowing higher interest rates. Unfortunately, it is an inopportune time for Francophone Africa to be raising interest rates, as the economies of the region are now relatively fragile. Yet, as long as market participants see no exchange risk between the CFA and the Franch franc, investors will arbitrage French interest rates against CFA interest rates, forcing a rise in CFA rates.

Events in Europe may ease temporarily some of the pressure on the CFA countries in the near term by reducing French interest rates. Should the French franc devalue within the European Monetary System —a strong possibility—French interest rates would likely decline vis-á-vis German rates. In the event of a franc devaluation against the DM, foreign-exchange-market investors would expect no new devaluation for at least six months or so. Hence, funds would flow from Germany to France to capture the higher interest rates in France, which would push French interest rates down over this period.

Over the longer run, however, the problem will persist as the French socialist policies ultimately lead to higher inflation in France, higher interest rates, and new fears of further devaluations. Nevertheless, the French-speaking African nations are expected to choose, then as now, to maintain the CFA franc-French franc currency link on the assumption that the benefits will continue to outweigh the costs of higher interest and inflation rates.

Wally V. Koch
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An Economic View of the Balance of Payments

Few economic concepts are as widely used—or as generally misunderstood and misapplied—as the balance of payments (BOP). Many of the term's misapplications arise from attempts to infer substantive meaning from accounting conventions that correspond imperfectly to the economic concepts policymakers have in mind. This problem cannot be completely resolved, since international transactions are recorded in the BOP under accounting definitions.

The U.S. BOP is a summary of all international transactions. Since it is based on double-entry bookkeeping, total debits always equal total credits; in a trivial sense, the overall BOP always balances. Of interest to economists and policymakers, however, is *how* it balances—that is, which sections, or accounts, of the BOP are in surplus and which are in deficit, and why. There is no single BOP definition, in either an accounting sense or an economic sense, that is appropriate for all situations. Thus, correct use of the BOP lies in applying the proper concept to the proper problem.

A useful approach to understanding the BOP lies in relating the various bookkeeping definitions to imbalances in the markets identified by economists in analyses of the "general equilibrium" of the domestic economy. An imbalance in a balance-of-payments account can then be thought of as corresponding roughly to excess demand or supply in one of these markets. Thus, the BOP concepts most often reported in the press—the balance on merchandise trade, the balance of goods and services, and the current account—are all ways of describing excess demand or supply in what economists call the "goods market" (which actually includes both goods and services). The balance on the capital account represents the excess demand or supply in the "bond market" (a term used by economists to encompass all financial assets not defined as money, such as stocks, bonds, and short-term financial paper). Finally, international-reserve movements, recorded in the U.S. BOP as the change in net holdings of U.S. Treasury instruments by foreign monetary authorities—reflect excess demand or supply in the domestic "money market" (see below).

BOP and Corresponding Markets

BOP Component	Domestic Market
Balance on Merchandise Trade Balance on Goods and Services Balance on the Current Account	Goods Market
Capital Account Balance	Bond Market
Change in International Reserves (Exchange Market Adjustment)	Money Market

The economically relevant definition of the BOP in a given situation depends upon imbalances in the domestic market to which it is directly related. For example, an excess supply of money will be reflected in an outflow of foreign reserves; since the United States has traditionally been a reserve-currency country, this flow is observed as an increase of foreign official holdings of U.S. debt. On the other hand, an excess domestic demand for goods may manifest itself as a negative U.S. balance of trade position.

The goods market seems to be the source of much of the confusion about the U.S. external position. A deficit in the merchandise trade account is often cited as a serious problem—even when the balance of goods and services is in surplus. In fact, even the goods and services account is an incomplete measure of activity in the "goods market." More useful is the entire current account, which comprises goods, services, and unilateral transfers.

The various accounting measures of imbalances in the goods market are often abused by diverse groups seeking policy actions favorable to their interests. For example, U.S. protectionists are fond of citing the huge U.S. merchandise trade *deficit* as justifying higher tariffs or quotas. Some foreigners, however, point to the U.S. current-account *surplus* to argue that the United States should reduce barriers protecting American industry, decrease subsidies to American exporters, or revalue the dollar. Obviously, this sort of "partial equilibrium" analysis leads to recommendations of partial solutions that can sometimes cause general problems for the economy.

Similar misunderstandings pervade discussions of bond-market imbalances. For example, net reinvested earnings of U.S. incorporated affiliates show up in the BOP as a debit to the capital account (and a credit to the current account). Partial analysis—pointing to this "capital outflow"—could be used to build support for capital controls, even though the "outflow" might exist only in an accounting sense. The capital account of the BOP can be a useful guide to the health of the domestic bond market, but it requires careful analysis.

Finally, changes in international reserves can easily be misinterpreted, since excess demand or supply in the domestic money market can also show up as changes in the external value of the dollar. The BOP reserves account can be said to reflect the "overall" U.S. payments position. But it is an imperfect measure. The health of the dollar can be better gauged by looking directly at domestic money-market imbalances.

In sum, the various BOP definitions are meaningful for policy only if the accounting definitions are interpreted properly in the correct economic sense. The BOP data should be used for policy formulation only with great care, and it should be kept in mind that policies based on partial analysis can do severe damage to the overall economy.

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